WPS4655

POLICY RESEARCH WORKING PAPER 4655

Broadening the Offering Choice of Corporate Bonds in Emerging Markets:

Cost-Effective Access to Debt Capital

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June 2008

Policy Research Working Paper 4655

Abstract

The development of corporate bond markets has been constrained in many emerging economies, partly because the regulatory model is implicitly designed for stand-alone public offerings. Corporate bonds are intrinsically more suitable for non-retail investors than for retail investors. Nonetheless, the prevailing regulatory model puts an excessive emphasis on disclosure and investor protection as well as government oversight, regardless of targeted investors. Such a non-differentiating regulatory approach disconnects issuers from investors by considerably raising opportunity costs to issuers. Broadening the choice of offering methods would lower corporate bond issuance costs, thereby allowing more issuers to finance their investments with bond issues. Additional forms of offerings are traditional private placements, institutional offerings, and shelf registration facilitated by integrated disclosure.

This paper—a product of the Capital Markets Division, Corporate Governance and Capital Markets Department—is part of a larger effort in the department to assist member countries in developing the capital market for their economic development. Policy Research Working Papers are also posted on the Web at http://econ.worldbank.org. The author may be contacted at tendo@worldbank.org.

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Acknowledgments

The author gratefully acknowledges the comments of Phillip Anderson, Stijn Claessens, Claire Grose, Robert Strahota, Richard Symonds, and Dimitri Vittas. In addition, the author thanks Shinichi Tanaka and Vivi Zhang for excellent research assistance and is especially grateful to Yoshiko Saito for conducting a survey and analyzing the results and to Zamir Iqbal for advising on Islamic finance. The findings, interpretations, and conclusions are the author's own and should not be attributed to the World Bank, its Executive Board of Directors, or any of its member countries.

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1. Introduction

The purpose of this paper is to propose an alternative to the currently prevailing model for developing the corporate bond market in emerging markets. The prevailing model has placed too much emphasis on public bond markets and too little emphasis on more flexible offering methods, including private placements. The issuer's opportunity costs associated with public offerings keep the corporate bond market from gaining momentum for development. The efficiency of the primary market matters more to corporate bond market development than that of the secondary market.

Broadening the offering methods of corporate bonds would help invigorate the development of the corporate bond market. Despite its strongly advocated role in economic development, the corporate bond market remains marginal at best in most emerging economies (Table 1.1). Impediments are often found in the macroeconomic environment, the legal system, the financial regime, the regulatory regime, the tax regime, the corporate governance, the market infrastructure, and the structure of the financial industry. In addressing these problems in a particular country, most efforts have been implicitly confined to the market of stand-alone public offerings. In contrast, advanced markets have long embraced a broader choice of offering methods—including traditional private placements, institutional offerings, and shelf registration—that are complementary to stand-alone public offerings (Figure 1.1).[1] These additional methods are likely to catalyze the development of the corporate bond market because they are cost-effective in reaching mainstream investors in corporate bonds.

An expected virtuous cycle for the corporate bond market has yet to materialize in many emerging markets. The Asian financial crisis in the late 1990s prompted policy makers to assume that the corporate bond market would help supply long-term debt capital in a sound and efficient manner.[2] The corporate bond market was also expected to supply debt

[1] Krishnaswami, Spindt, and Subramaniam (1999) looked at a sample of 297 U.S. non-finance companies that had a firm size exceeding US$100 million as of year-end 1986 and that were likely to have access to both private and public debt markets. For a typical firm in that sample, more than 60 percent of all its long-term debt was privately placed from 1987 to 1993.

[2] Hakansson (1999) argues the merits of a well-developed corporate bond market in the wake of the Asian financial crisis.

Table 1.1: Equities, Bonds, and Bank Loans Compared to Nominal GDPs in Selected Developing and Industrial Countries

As of December 2007+
(U.S. dollars in billions, % of GDP)

	GDP	Savings (Dec. 2006)		Total bonds		Government bonds		Corporate bonds		Equities (Dec. 2005)		Bank claims on private sector (Dec. 2005)	
Country	(Dec. 2006)	Amount	% of GDP	Amount	% of GDP	Amount	% of GDP	Amount	% of GDP	Amount	% of GDP	Amount	% of GDP
Argentina	214.2	61.4	28.6	75.7	35.4	63.1	29.4	12.7	5.9	62.0	33.8	18.8	10.3
Brazil	1,067.5	210.3	19.7	952.2	89.2	694.1	65.0	258.1	24.2	450.1	51.0	332.1	37.6
Chile	145.8	51.0	34.9	42.7	29.3	14.5	10.0	28.2	19.3	131.8	110.9	74.2	62.4
Mexico	839.2	173.4	20.7	355.4	42.3	191.6	22.8	163.8	19.5	206.7	26.9	129.1	16.8
Peru	92.4	26.8	29.0	22.1	23.9	17.5	18.9	4.6	5.0	28.5	35.9	14.3	18.1
Bolivia	11.2	2.4	21.9	na	na	na	na	na	na	2.1	22.6	3.6	38.2
Colombia	153.4	32.3	21.1	52.2	34.1	51.4	33.5	0.8	0.5	36.0	29.2	27.4	22.3
India	911.8	283.2	31.1	458.4	50.3	416.9	45.7	41.5	4.6	572.6	71.1	297.1	36.9
Indonesia	364.8	107.1	29.4	88.0	24.1	78.7	21.6	9.3	2.5	77.9	27.2	66.0	23.0
Korea	888.0	274.3	30.9	1,107.5	124.7	466.0	52.5	641.5	72.2	579.1	73.2	995.4	125.8
Malaysia	150.7	56.8	37.7	178.6	118.5	69.7	46.2	108.9	72.3	188.3	144.0	165.6	126.6
Philippines	117.6	15.4	13.1	54.2	46.1	52.6	44.8	1.6	1.3	34.8	35.4	30.1	30.6
Thailand	206.3	65.6	31.8	136.0	65.9	94.7	45.9	41.3	20.0	120.3	68.2	159.6	90.5
Czech Rep.	143.0	43.2	30.2	104.4	73.0	84.9	59.4	19.5	13.6	35.3	28.5	41.0	33.1
Hungary	112.9	28.9	25.6	70.1	62.1	63.5	56.2	6.6	5.8	31.2	28.3	53.0	48.0
Poland	338.7	66.4	19.6	162.6	48.0	162.6	48.0	na	na	84.2	27.8	79.7	26.3
Slovakia	55.0	13.4	24.3	19.0	34.6	19.0	34.6	na	na	4.5	9.6	15.0	31.7
Russia	986.9	324.5	32.9	40.6	4.1	40.6	4.1	na	na	554.2	72.5	173.5	22.7
South Africa	255.2	43.5	17.1	120.7	47.3	72.2	28.3	48.5	19.0	518.4	214.1	160.5	66.3
U.S.*	13,163.9	1,677.6	13.5	24,313.8	184.7	6,590.6	50.1	17,723.2	134.6	16,757.8	135.0	22,952.9	184.9
Japan*	4,368.4	1,126.2	24.8	8,855.7	202.7	7,145.1	163.6	1,710.7	39.2	4,810.3	106.1	4,440.6	97.9
U.K.	2,377.0	322.7	13.6	1,359.0	57.2	903.0	38.0	456.0	19.2	2,974.5	135.1	3,416.4	155.2
Germany	2,896.9	671.9	23.2	2,629.6	90.8	1,393.0	48.1	1,236.6	42.7	1,224.6	43.8	3,103.3	111.0

Sources: BIS Quarterly Review June 2008, World Development Indicators, World Bank Financial Sector Development Indicators, staff calculation.
Notes:
1. na = not available
2. GDP figures are nominal and taken from the World Bank Database, World Development Indicators.
3. Savings are from the World Bank Database, World Development Indicators.
4. Bonds are those in local currency taken from *BIS Quarterly Review* June 2008. Corporate bonds include those by financial institutions and corporate issuers, except for Colombia and the Philippines. Bonds as a percentage of GDP are estimated based on nominal GDP for 2006.
5. Equities are those in local currency taken from the World Bank Database, World Bank Financial Sector Indicator.
6. Bank claims on the private sector are from the World Bank Database, World Bank Financial Sector Indicator. Bank claims are the closest available proxy for bank loans, although claims could also include other claims, such as equity securities. Bank claims on the private sector are taken here as approximations for loans to the private sector.
+ As of December 2006 for GDP and Savings, except for U.S. and Japan (*as of December 2005 for Savings). As of December 2005 for Equities and Bank claims.

investment products in local currencies to medium- and long-term investors, including contractual savings institutions. Efficient matching of demand and supply would generally reduce funding costs, increase investment yields, and minimize refinancing as well as reinvestment risks. The transferability of corporate bonds in the secondary market would reduce funding costs by lowering a liquidity premium. Thus, lessening maturity mismatches on the balance sheets of banks and contractual savings institutions would reduce systemic risk and increase financial efficiency in the economy through the efficient reallocation of debt capital. However, this scenario has not occurred thus far in many emerging economies.

Corporate bond market development has long focused on the market of stand-alone public offerings, overlooking hidden opportunity costs. In many emerging markets, the corporate bond market implies the market of stand-alone public offerings. Most regulatory efforts have been directed at enforcing the best possible disclosure for stand-alone public offerings. As a result, the overemphasis on stand-alone public offering norms has been making corporate bond issuance in emerging economies unnecessarily cumbersome and time consuming, compared with issuance of bank loans. The time-consuming nature of financing

Figure 1.1: Offering Methods of Corporate Bonds

Offering Type	Traditional Private Placements	Institutional Offerings	Shelf Registration	Stand-alone Public Offerings
Investor Type	Institutional / affluent investors (Non-private customers)	Qualified investors (Wholesale players)	Institutional investors (occasionally, retail investors)	Retail investors (Private customers)
Disclosure and Restrictions	Unregulated/tailor-made disclosure Large denomination Unlisted/Non-rated	Semi-formal disclosure Large denomination Unlisted	Formal and full at registration and integrated disclosure for individual issues	Formal and full Small denomination
Transferability and trading	Restricted	Tradable among Qualified Investors on closed ECNs or "exchange-regulated markets"	Freely tradable on exchanges and OTCs	Freely tradable on exchanges and OTCs

Source: Author.

with corporate bonds in emerging economies substantially increases opportunity costs to the borrower. Opportunity costs in stand-alone offerings have been significantly responsible for keeping corporate bond markets marginal, at best, in most developing economies.

Gearing the primary market policy more toward non-retail investors is likely to accommodate corporate bond market development in emerging economies. The primary market and non-retail investors are the two pillars of a corporate bond market. However, little policy research has been done on the efficiency of the primary market of corporate bonds, let alone that in emerging markets.[3] A better understanding of the primary market and non-retail investors, especially institutional investors, would likely help moderate the overemphasis on the norms for stand-alone public offerings in corporate bond market development.

This paper is intended to provide policy makers, regulators, and other stakeholders of emerging economies with a policy impetus toward corporate bond market development. The rest of this paper is organized as follows. Section 2 reviews the literature on corporate bond market development in developing economies. Section 3 analyzes the characteristics of

[3] Friedman and Grose (2006) examine legal and regulatory measures that can be taken to promote access to the primary market of equities in emerging market economies, including private placements.

corporate bonds. Section 4 explores the rationales for modification of regulatory focus in corporate bond market development. Section 5 examines the three alternative offering methods. The final section summarizes the preceding discussions.

2. Literature on the Primary Market for Corporate Bonds

Far less policy research has been done on corporate bond market development in emerging economies than on government debt markets. Discussion of corporate bond markets tends to be supplementary to that on government debt markets in the literature on emerging fixed-income markets. Publications by international organizations extensively review the structure and practices of emerging debt markets or those of advanced markets for policy makers in emerging markets (see, for example, BIS 2002; IOSCO 2002; OECD 2002; World Bank 2001). An increasing number of research papers, including the foregoing, have deepened development institutions' understanding of emerging corporate bond markets in individual countries or regions by documenting these markets' characteristics and roles (see, for example, Aguilar and others 2006; Akamatsu 2005; Batten, Fetherston, and Szilagyi 2003; BIS 2001, 2002, 2007; Bose and Coondoo 2003, Braun and Briones 2006; Castellanos and Martínez 2006; de Brun and others 2006; De la Torre and Schmukler 2007; Fernández and others 2006; FOA 2005; IOSCO 2005; Jiang and McCauley 2004; Kim, Ho, and St Giles 2003; Leal and Carvalhal-da-Silva 2006; Marathe 2006; Mirkin and Lebedeva 2006, Park and Kim 2004; Rand Merchant Bank 2001; Reininger, Schardax, and Summer 2002; Scott and Ho 2004; Sy 2007). Most of them report that, compared with bank loan markets and government bond markets, corporate bond markets are underdeveloped in emerging countries or regions.

Meanwhile, studies on impediments to market development paid attention to the structure of emerging economies. Sharma (2000) indicates that the close and interlocking links between banks, companies, and governments in Southeast Asia are impeding corporate bond market development. Similarly, Dickie and Fan (2005) and IMF (2005) point out some bank resistance to corporate bond market development. BIS (2007) also identifies inadequate reliable information (which is partly due to weak corporate governance), a narrow investor base, and competition from commercial banks as impediments to corporate bond market development. Gormley, Johnson, and Rhee (2008) show that smaller firms, even with their

better corporate governance structures, were unable to access the new capital markets when banks stopped lending in the Republic of Korea. As for Latin American countries, Borensztein, Eichengreen, and Panizza (2006: 20) reveal that the corporate bond market tends to be large in countries with less efficient banking sectors[4] and in "countries with the English legal code."[5] Fernández, Pernice, and Streb (2007) attribute small company and economy sizes to the underdevelopment of the corporate bond market in Argentina, Brazil, Chile, Colombia, and Peru.

Efforts to look into market microstructure have also begun. Zervos (2004) documents issuance cost information in Brazil, Chile, and Mexico, and IMF (2005) reviews issuance costs by management fees, registration, listing fees, and legal fees; credit rating fees; marketing costs; and taxes. Luengnaruemitchai and Ong (2005) argue that the high costs associated with corporate debt issuance have significantly deterred market development. These studies seem to have two limitations. First, the issuance costs that they refer to are limited to accounting costs but do not include opportunity costs of corporate bond issues as compared with bank loans. Opportunity costs count a lot in the issuer's choosing a financing option, as is shown later in this paper. Second, the corporate bond issues that they studied were stand-alone public offerings. Policy makers, regulators, and other market stakeholders need to view the potential for market development more broadly. Roldos (2004) sheds some light on the effect of the issuance process on market development, citing the underwriting process of 60 days in Brazil and the cost-effectiveness of private placements in Poland.

3. Characteristics of Corporate Bonds

Primary market efficiency significantly determines the activity level of a corporate bond market because corporate bonds are exposed to market forces mainly in the primary market rather than in the secondary market. The low liquidity of corporate bonds relative to government bonds is well known. Most corporate bonds cannot fully satisfy the attributes necessary for their secondary market liquidity. When regulatory and incentive frameworks are properly put in place, institutional investors prefer higher yields at acceptable risk over liquidity for a substantial part of their medium- and long-term investment portfolios.

[4] These countries have high banking spreads and high levels of bank concentration.

[5] That is, countries with common law legal systems.

Clarifying those intrinsic characteristics of corporate bonds would help improve the regulatory framework and market structure for corporate bonds in line with emerging market realities.

3.1 Lack of Liquidity Attributes

Corporate bonds lack the attributes necessary for secondary market liquidity. To keep the secondary market liquid, the government issues its bonds in a market-based, sizable,[6] widely distributed,[7] regular, predictable,[8] and transparent manner in a competitive environment. In addition, government bonds are usually the most creditworthy in a country. By contrast, corporate issuers cannot satisfy most of these attributes in their bond issues. Corporate issuers usually have little economic incentive to care about the secondary market. Large financial institutions, utility companies, and some state-owned enterprises may be exceptions. They may be able to meet some of the attributes to gain some liquidity in the secondary market because they raise substantial funds frequently, regularly, or both.

3.2 Market Windows

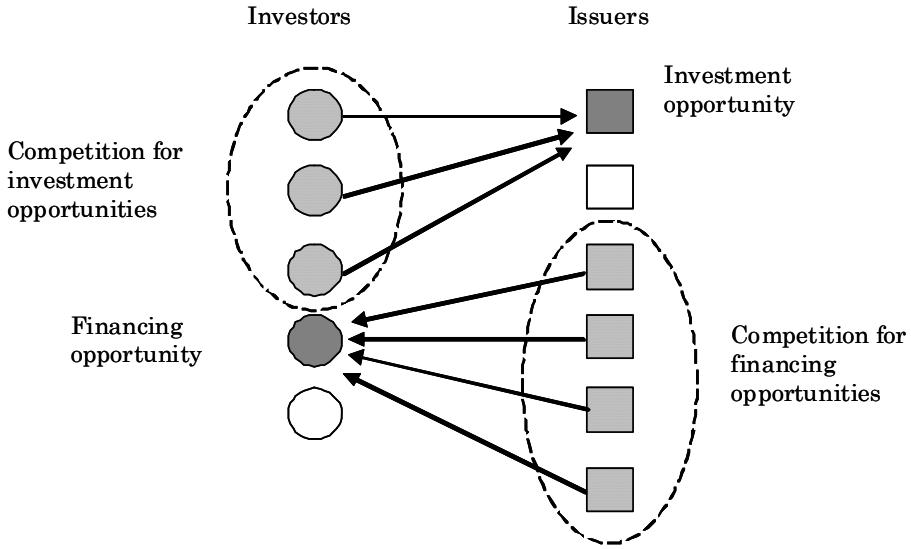
Investors and issuers often use corporate bonds to meet their medium- to long-term needs. Specific investment and financing needs face investors and issuers under ever-changing business environments and financial market conditions. Investors differ in investment objectives, preferences, capacities, and constraints, including tax and accounting considerations. An internal or external event could impact investors' portfolios differently and investors may react to the impact differently. The differences will likely create a short-lived opportunity for issuers to exploit particular types of investors (a *market window*). Some investors may be willing to pay a premium if the timing or features of a debt product satisfy their particular needs. Conversely, issuers will also be faced with unique or markedly distinct

[6] Issuing practices and admission criteria to automated trading systems like MTS in highly or reasonably liquid markets suggest that the issue size necessary for the targeted liquidity is approximately US$5 billion or more in the French, German, Japanese, and U.S. markets; US$3 billion in the Dutch and Portuguese markets; US$1.5 billion in the South African market; US$1.3 billion in the Singaporean market; US$1.1 billion in the Thai market; and US$0.5 billion to US$0.8 billion in the Malaysian market.

[7] The government may impose limits on auction allocations; may privately place bonds with a particular group of investors; or may, under a primary dealer system, appoint foreign dealers as primary dealer.

[8] The debt management office or its equivalent usually provides "issuance calendars."

Figure 3.1: Continuous Competition for Market Windows in an Efficient Primary Market



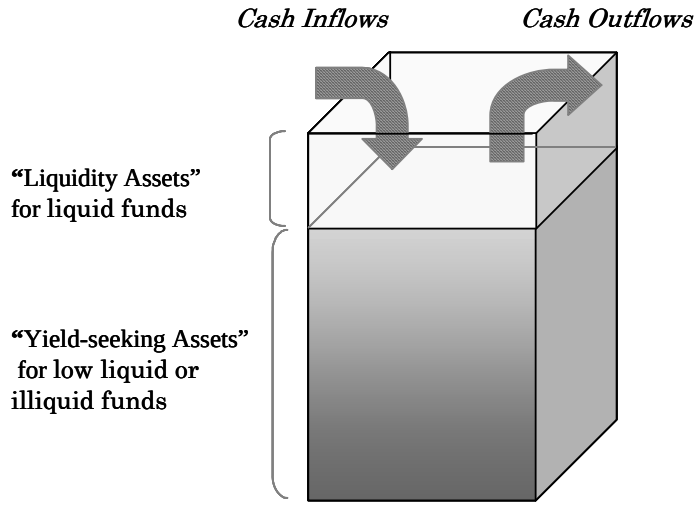
In a marketplace, investors are competing with each other for investment opportunities provided by issuers, and issuers are also competing with each other for financing opportunities provided by investors. Investors and issuers move quickly to capture "market windows".

Source: Author

funding needs from time to time. They may consequently wish to pay some premium for the fulfillment of those requirements.

Investors and issuers achieve their returns or costs on corporate bonds by capturing market windows opportunistically in the primary market. After investors have bought corporate bonds on the primary market or on the secondary market immediately following the issuance, those bonds are seldom available for sale in the secondary market. Therefore, investors have the best chance to achieve their desired returns on a large block of corporate bond investment through market windows in the primary market. Most market windows for issuers or investors tend to be brief. In an efficient primary market, investors compete with each other for a finite set of opportunities offered by issuers. The same holds true for issuers. In such a market, both issuers and investors can and should be able to issue or invest on short notice, which creates *primary market efficiency* (Figure 3.1).

Figure 3.2: Liquidity Assets and Yield-Seeking Assets in an Investment Portfolio



Money that frequently inflows and outflows is marginal to the whole investment portfolio. The rest does not need to stay liquid at all times.

Source: Author

3.3 Buy and Hold

The "buy and hold" strategy, which is often viewed as responsible for the low liquidity of corporate bonds, is rational to many institutional investors. On many occasions, institutional investors are likely to achieve their investment objectives better by not trading corporate bonds frequently.

Most institutional investors do not need to keep a large part of their portfolio liquid. Only a small part of a portfolio may flow out on demand or with a short notice.[9] A substantial part of the liabilities of institutional investors is medium or long term, or both. Therefore, assets that they hold for liquidity purposes (*liquidity assets*) can be relatively small[10] (Figure 3.2). In addition, they are usually able to fund temporary shortfalls in the

[9] An exception is open-end mutual funds. They keep a larger part of their portfolios liquid to meet their unit-holders' redemption requests than other institutional investors do.

[10] The actual size of this illiquid component varies and fluctuates, depending on investment objectives, restrictions, outlook for market conditions, and other factors.

market or from banks, if such shortfalls occur. Consequently, most institutional investors investing in corporate bonds can hold the bonds for a long period or to maturity.

The investor would be better off investing illiquid funds in higher-yielding assets (*yield-seeking assets*) to the extent that its risk-tolerance parameters permit it to forgo liquidity. Corporate bonds are less liquid and riskier than government bonds, but they yield higher returns than government bonds. Choosing high-quality issuers, conducting thorough due diligence, structuring issues in a legally robust manner, and diversifying a portfolio mitigate risks associated with investments. Institutional investors are usually resourceful enough to take these risk-mitigating measures.

The low liquidity of corporate bonds, in turn, reinforces institutional investors' buy-and-hold behavior. Bid-ask spreads, if any, are wide in a less liquid market. Selling a large block of corporate bonds would have an adverse market impact,[11] widening the bid-ask spread. Consequently, selling less liquid bonds in the secondary market would significantly lower their realized rate of return compared to their yield to maturity at the time of purchase. Institutional investors thus trade corporate bonds only when their trading needs justify large trading costs.

3.4 Credit Risk

Credit risk also distinguishes investing in corporate bonds from investing in government bonds. The investor can address the credit risk of corporate bonds in two phases: how to assess and mitigate the likelihood of default on bonds (ex ante credit risk) and how to assess and maximize the likelihood of recovery of defaulted bonds (ex post credit risk). Most events of default on bonds occur when the issuer goes bankrupt or, if the bonds are guaranteed, when both the issuer and the guarantor go bankrupt.

The investor controls ex ante credit risk through elaborate credit analysis, thorough due diligence, diversified investment, and restrictive covenants. To choose quality issuers, the investor relies on the issuer's self-evident factors, such as its size, profitability,

[11] A market impact is the effect of the positions bought or sold on the price paid or received for a security. If an order lot is large relative to the actual liquidity, the order will be executed only at a price low or high enough to meet the required volume of demand for or supply of the security. The difference between the executed and initially quoted prices is called the *market impact* or *price impact*. Market impact is often the largest component of trading cost for a large transaction and for a large investor.

experience in the debt market, leverage and coverage ratios, and credit rating (if any). Due diligence allows the investor and the intermediary to verify the issuer's mandatory and voluntary disclosure and, if necessary, to demand additional disclosure. Setting and enforcing strict or specific covenants requires the investor and the intermediary to have bargaining and monitoring capacities. Diversifying the investment portfolio limits the investor's investment in a particular issuer, industry segment, or geographic area. These preventive measures are too costly for individual investors to take unless the issuer is listed on an exchange, complies with ongoing disclosure, or is credit rated. Listing, ongoing disclosure, and credit rating may not be economical for the issuer unless it issues bonds in a large amount, and frequently, or both.

The investor attempts to manage ex post credit risk by securing its claims with collateral, preserving seniority over other claims, relying on the absolute priority rule,[12] renegotiating bond terms, or restructuring the issuer. However, these measures have limitations. The bankruptcy laws define the procedures for forcing the bankrupt issuer to repay its obligations and the limits of the investor's legal ability to force the repayment. However, the procedures and limits may become blurred in a complex default and restructuring situation and may also be subject to court judgments. As such, these measures are likely to be too costly for individual investors to take. Meanwhile, the trustee may have to represent hundreds or thousands of bond investors under the trust indenture, whose interests or goals are diversified (*diffuse ownership problem*). In such circumstances, the trustee can hardly be flexible in renegotiating bond terms or restructuring the issuer when a default occurs, which prevents the trustee and the defaulted issuer from promptly reaching an agreeable solution for the default (*holdout problem*).[13]

[12] In principle, bankruptcy laws require senior creditors to be fully paid before junior creditors and stockholders may receive any payment in the event of liquidation. However, a court judgment may deviate from this rule when the court finds increasing the defaulted issuer's value or continuing the issuer's operations (deviations or violations of absolute priority) beneficial to creditors. The application of the rule varies from jurisdiction to jurisdiction and from case to case.

[13] For example of the trustee's inflexibility, see section 316(a) of the U.S. Trust Indenture Act of 1939.

Table 3.1: Issuing Expenses of Public Issue of Corporate Bonds

Recipient	*Typical expense items*
Regulator or government	Stamp duty, issue license fee (may take form of prospectus reviewing fee, securities registration fee, and so on)
Stock exchange	Listing fee
Intermediaries	Underwriting, management, and placement fees ("gross spread"), trustee fee, payment agent fee, listing agent fee, intermediaries' out-of-pocket expenses
Professionals	Legal fee, accountant's fee, rating fee
Miscellaneous	Prospectus printing expenses, road show expenses, staffing costs

Source: Author.
Note: The issuing expenses listed are accounting costs only; they do not include opportunity costs incurred during the issuing process.

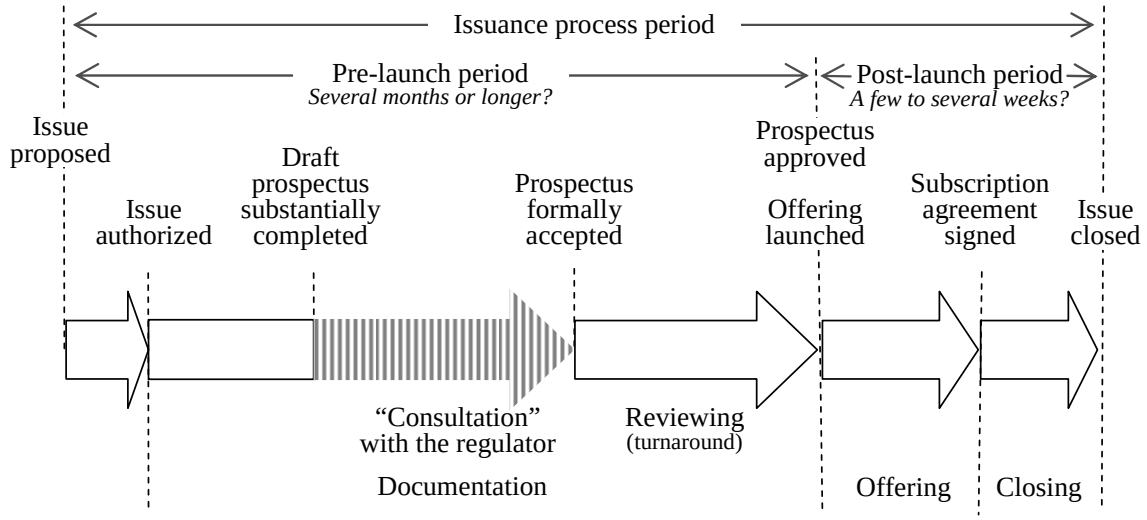
3.5 Issuing Costs

Corporate bond issues incur issuing expenses in addition to coupon payments. The issuing expenses of publicly offered corporate bonds consist of accounting and opportunity costs. The accounting costs include taxes or fees payable to the regulator or the government, to the stock exchange, to intermediaries, and to professionals, as well as miscellaneous expenses (Table 3.1). The opportunity cost is potential gains that the issuer forgoes by choosing a public offering of bonds over a bank loan to finance an investment project. It emanates largely from the pre-launch period of a bond issue.

The accounting costs of a public offering are rather fixed because of intermediaries' costs of distribution. Most expense items are variable or semi-variable. For example, the gross spread—consisting of underwriting, management, and placement fees—accounts for the great majority of the issuing expenses and is normally charged as a percentage of the bond issue amount. The rate ranges roughly from one-eighth of 1 percent to a few percentage points of the issue amount. By contrast, some expenses, such as legal fees, tend to be inelastic to the issue amount. The gross spread is likely to have a larger effect on the economies of scale of issue size than will any explicitly invariable expenses. In a competitive market, the intermediaries charge the gross spread at a lower rate for a larger issue size.[14] They are usually reluctant to underwrite, manage, or place a public offering of a small

[14] Other factors, such as the issuer's credit quality or bargaining power and the intermediary's desire to penetrate into particular issuers, may lower the gross spread that the intermediary charges.

Figure 3.3: Time Frame for Stand-Alone Public Offering in Emerging Markets



Source: Author.

amount, or they increase the fee rate for an issue of a small amount—probably because the cost of mobilizing a retail sales force or a large distribution network is inflexible.[15]

The most critical cost element in a stand-alone public offering could be uncontrollable opportunity costs in complying with disclosure requirements. The prospectus review process (turnaround time) is uncertain and tends to be unpredictably prolonged and costly (Figure 3.3). For an emerging market issue, the pre-launch period may take several months or even more. Furthermore, the issuer cannot really control the length of the pre-launch period. The regulator often encourages the issuer to consult or coordinate with the regulator before the issuer officially submits the offering prospectus for review and approval. The issuer also prefers this route to avoid being embarrassed by the regulator's possible disapproval of the prospectus. Where a regulation obliges the regulator to finish reviewing the prospectus in a predetermined period, the regulator may not officially accept the prospectus for review until it is fully satisfied with the contents of the prospectus. Pre-offering marketing activity, including book building, is not allowed before the prospectus is approved. Consequently, the consultation period tends to be unpredictably protracted, and the issuer incurs an opportunity cost.

[15] Some prior studies argue that the fixed costs of public offerings are larger than those of private placements (Blackwell and Kidwell 1988; Krishnaswami, Spindt, and Subramaniam 1999; Smith 1986; Yaman 2005).

The opportunity cost of disclosure compliance is a function of the expected rate of return of an investment project. The total cost of bond issuance F_t and the opportunity cost of bond issuance relative to bank borrowing f_o can be denoted as follows:

$$F_t = (a_t + D\,E(Ri))\,(T_{pr} + T_{po}) + a_v D + a_f$$

$$f_o = D\,E(Ri)\,(T_{pr} + T_{po} - T_b),$$

where

F_t is the total cost of a stand-alone public offer, f_o is the opportunity cost of a stand-alone public offer, a_t is the accounting cost per time unit of a stand-alone public offer variable with the length of the pre-launch period, D is the amount of the debt to be issued through a stand-alone public offer, $E(Ri)$ is the expected rate of return on the project in which the issuer will invest the debt proceeds, T_{pr} is the length of the pre-launch period, T_{po} is the length of the post-launch period, T_b is the length of the bank loan processing period, a_v is the accounting cost of a stand-alone public offer variable with the amount of the debt to be issued, and a_f is the fixed accounting costs of a stand-alone public offer.

The borrower (issuer) would likely choose to take a bank loan instead of issuing bonds when the issuance cost exceeds the benefit of the bond issue over the bank loan.[16,17] The bond issuance cost model above implies some of the borrower's behavior. First, a better prospect for the project would discourage the borrower from a bond issue (the higher the expected rate of return is, the larger the opportunity cost will be).[18,19] Second, the uncertainty of the ultimate opportunity cost may turn the borrower toward a bank loan, whose cost is relatively certain. The borrower has little control over the length of the pre- and post-launch

[16] The benefit of the bond issue over the bank loan consists mainly of the positive present value of differences in coupon and interest payments, net of miscellaneous expenses such as paying agents' fees and listing fees that accrue after the closing of the bond issue.

[17] Some statutes may restrict bond issuance. Company laws in some countries provide for the approval of bond issuance at the general shareholders' meeting (instead of the approval by the board of directors only), set eligibility rules for bond issuance, and place limits on outstanding bonds, while such restrictions do not apply to bank loans.

[18] The preference of growing companies for private placements over public offerings may also be explained by contracting costs caused by moral hazards (Krishnaswami, Spindt, and Subramaniam 1999).

[19] The expected rate of return should be higher than the all-in cost of a bond issue. The *all-in cost* is the coupon rate plus the amortized accounting costs of a bond issue, including a primary issue discount or premium.

periods.[20,21] The pre-launch period may become infinite or extremely long, should the borrower miss a market window for the planned bond issue. Third, the borrower's choice between a bond issue and a bank loan could be highly sensitive to the length of the pre- and post-launch periods. The expected rate of return could be several times as large as the funding spread between a bond issue and a bank loan.[22]

A protracted reviewing period could also reflect high contracting costs of issuers in emerging economies. The market regulator primarily represents the public, demanding extensive disclosures from the issuer. Contracting costs to the issuer are likely to be lower with non-retail investors than with the public, especially in the case of emerging economies, because of the closed ownership structure and weak corporate governance environment prevailing in emerging economies. The difference in contracting costs between institutional investors and the public could be so large that the issuer may be discouraged from considering a public offering.

3.6 Primary Market Efficiency

Primary market efficiency would increase a supply of corporate bond issues more than secondary market liquidity would. *Primary market efficiency* refers to the ability of the issuer and intermediaries to offer securities expediently to investors to capture a market window. As has been discussed earlier, the intrinsic characteristics of corporate bonds generally limit the room for secondary liquidity enhancement. Instead, government bonds and money market instruments play a role as liquidity assets in investment management. Infrequent issuers would have difficulty translating secondary market liquidity, if any, into a lower coupon rate in the primary market. Only a small number of large, high-quality, and

[20] The bank loan processing period (T_b) is usually much shorter than the total bond issuance period ($T_{pr} + T_{po}$) because the borrower normally has taken some bank loans by the time the borrower contemplates bond issuance and because banks are already familiar with the borrower's operations and financial conditions.

[21] The issuer may consider bridge financing a project with a bank loan to reduce opportunity costs before refinancing the project with a public offering of bonds. In such a case, however, the issuer has to have substantial bargaining power with the bank to terminate the loan at its discretion. Bridge financing in the money market might be an alternative. However, the capital market that has a liquid money market open to non-bank issuers is likely to have a broad choice of offering methods already in place. In addition, the issuer with access to the money market is likely to be listed on a stock exchange and well experienced in bond issuance.

[22] The spread, if any, will be the main benefit of the bond issue in addition to a fixed interest cost, low refinancing risk, and financing source diversification.

regular issuers can turn secondary market liquidity into a lower coupon rate. Thus, the degree of primary market efficiency significantly affects economies of corporate bond finance.

4. Regulatory Focus on Non-retail Investors

The regulator can differentiate the degree of investor protection by type of investors. The expeditiousness of offering procedures saves issuing expenses and opportunity costs and reduces risk. However, the issuance process period is often too long because the regulatory focus of corporate bond issuance has been placed on protection of the public. In reality, non-retail investors, especially institutional investors, are the core investor base for corporate bonds. Conventional regulation for corporate bond issuance may have been disconnecting corporate bond issuers and investors in emerging economies.

4.1 Expeditious Procedures

The expeditiousness of offering procedures is a matter not only of expenses and opportunity costs but also of risk management. The immediacy of transactions has become increasingly important even to issuers in emerging markets to limit market risk. Most emerging economies have been integrated into the volatile global economy. Yet issuers in most emerging markets do not have means to hedge against market risk for seven to eight months or more. Even if they had it, it would be too expensive.

A typical stand-alone public offering of corporate bonds in an emerging market takes a few months or sometimes more than a year.[23] FOA (2005) reports that the issuance process takes 13 to 14 months in China. A survey of 28 countries done for this paper shows that the time for a stand-alone public offering ranges from 8 to 51 weeks (Box 4.1). By comparison, in the Eurobond market, a public offering for a new or infrequent issuer takes two months (eight weeks) (Table 4.1) and a few days or hours for a frequent issuer (Table 4.2). The reduction of the approval process from between 9 and 12 months to no more than 15 days seems to have contributed to the recent emergence of the Malaysian corporate bond market (BIS 2007).

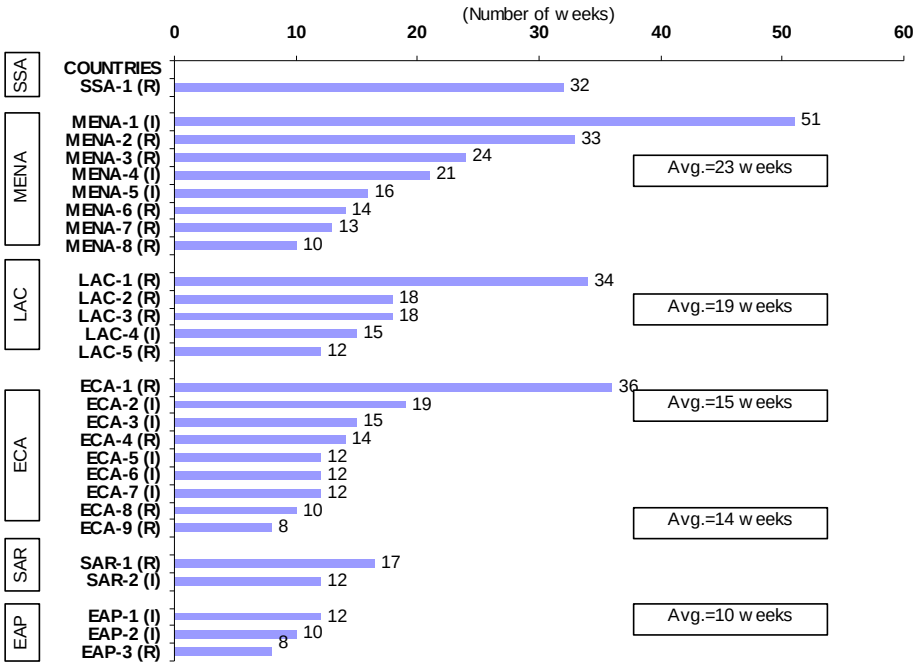
[23] This period is calculated from the time the issuer resolves the issuance of bonds until the closure of the issuance.

Box 4.1: Survey on Duration of Corporate Bond Issuance Processes

A survey was conducted on the duration of corporate bond issuance processes in emerging markets by e-mailing a response format to 70 regulators and approximately 30 intermediaries in emerging markets from October 2007 to March 2008. The regulators and intermediaries were asked the number of weeks that corporate issuers realistically take for each of the following: bond issuance authorization by the issuer, documentation, prospectus review by the regulator, offering, and closing of stand-alone public offerings (see Figure 3.3) in their markets.

Useful responses were collected from the regulators and intermediaries of the following countries: Bangladesh, Brazil, Bulgaria, Chile, China, Colombia, the Czech Republic, the Arab Republic of Egypt, Indonesia, Israel, Kazakhstan, Malta, Morocco, Oman, Poland, Romania, Sri Lanka, Thailand, Trinidad and Tobago, Turkey, Uganda, the United Arab Emirates, and Uzbekistan. The responses are not necessarily consistent, and they are small in number. Therefore, the results are not suitable for a rigorous analysis. Nonetheless, they provide a general view of the duration of the corporate bond issuance processes (see Figure 4.1).

Figure 4.1: Total Number of Weeks for Issuance, by Country and Region



Note: SSA = Sub-Saharan Africa, MENA = Middle East and North Africa, LAC = Latin America and the Caribbean, ECA = Eastern Europe and Central Asia, SA = South Asia, and EAP = East Asia and Pacific Region; R = regulator and I = intermediary. Some responses did not provide the number of weeks for bond issuance authorization by the issuer, offering, or closing; in such cases, the author assigned one week to each of the processes.

Table 4.1: Bond Issuance Process in the Eurobond Market for New or Infrequent Issuers

Date	*Event*	*Responsibility*
X − 47 days	Mandate awarded	Issuer
X − 46 days	Document request list sent to issuer	Lead manager and lawyers
X − 43 days	Information received replying to the list	Issuer
X − 40 days	All regulatory approvals and all relevant authorizations applied for (in the issuer's home country), if required	Issuer
X − 39 days	First draft of offering circular distributed to issuer and to lead manager for comment	Lead manager and lawyers
X − 36 days	Initial comments on offering circular received from issuer and lead manager	Issuer
X − 33/34 days	Due diligence/verification meetings	Issuer and lead manager
X − 31 days	Revised draft of offering circular distributed to all parties, including LuSE	Lead manager and lawyers
X − 17 days	Preliminary comments received from LuSE and further comments received from all parties	Listing agent, lead manager, and lawyers
X − 15 days	Revised draft of offering circular circulated; subscription agreement and other documents distributed for review	Lead manager and lawyers
X − 8 days	Further comments received from LuSE	Listing agent, lead manager, and lawyers
X − 6 days	Further draft of offering circular circulated for final comments	Lead manager and lawyers
X − 4 days	All regulatory approvals and authorizations to be in place; final comments received from LuSE; draft subscription agreement and other documents approved by all parties; final draft of offering circular distributed for signoff	Issuer
X	Launch; commencement of road shows (could start earlier); any preliminary offering circular to be printed and distributed; documents distributed to managers for review	Listing agent and lead manager
X + 3 days	LuSE to sign off; bringdown due diligence call; pricing and allocation	Lead manager, issuer, and lawyers
X + 4 days	Signing of subscription agreement and other documents; printing of final offering circular	Issuer, lead manager, and lawyers
X + 9 days	Closing of the issue; listing to take place	Issuer, lead manager, and lawyers

Source: Author and his interviews with Euro market parishioners.
Note: X = launch date; LuSE = Luxembourg Stock Exchange (for example).

Aligning disclosure requirements with an actual investor profile by choosing the optimal offering method would shorten the issuance process substantially. Complying with disclosure requirements is most responsible for the long and uncertain issuance process period of corporate bonds (Figure 3.3). An issuance process period consists of the pre-launch period and the post-launch period. The former is mainly for producing disclosure documents and clearing them from the regulator, while the latter is for placing the securities offered. In an emerging market issue, the pre-launch period may take several months, whereas the placement period may take one to four weeks.

Table 4.2: Bond Issuance Process in the Eurobond Market for Frequent Issuers: Book-Building Method

Date	*Action*	*Communication medium*
$X - 1$ or 2 days	Lead manager requests syndicate members to conduct premarketing and may transmit to them a premarketing sheet with relevant public information.	Telephone and fax
X	Based on premarketing feedback, lead manager launches the transaction.	Telephone
X	Lead manager instructs syndicate members to log onto the Web site (in case an e-book-building system is used).	Telephone
X	Lead manager transmits syndicate members the official price-talk sheet via e-mail or Bloomberg message. The syndicate members submit to lead manager their orders either at a predetermined daily time or as the orders are taken.	E-mail, Bloomberg, or Web site[a]
Throughout book-building process	Lead manager accepts protection requests. A preliminary prospectus is issued to syndicate members.	Telephone and fax
$X + 2$ or 3 days	Lead manager prices the issue.	
Same day as pricing	Lead manager transmits pricing to syndicate members and confirms their acceptance of pricing.	E-mail, Bloomberg, or Web site
Within 1 day after pricing	Lead manager transmits final allotment notice.	E-mail, Bloomberg, or Web site
As soon as possible after pricing	(Final securities registration statement supplement is filed, if registration is required.)	
Before closing	Final prospectus supplement is issued, and its receipt is acknowledged by the exchange.	E-mail, Bloomberg, or Web site
Before subscription	Other issue materials are distributed by hand or by fax.	
$X + 5$ days	Subscription	
X +7 or more days	Closing	

Source: Author and his interviews with Euro market practitioners.
Notes: a. Captive or open e-bookbuilding system. 'Bookrunner' intranet screen of IPMA is an open system

4.2 Regulatory Focus

The regulatory focus of corporate bond issuance has been placed on the protection of the public in many emerging markets. This regulatory stance assumes that each issue of corporate bonds may attract many financially unsophisticated or uninformed retail investors. Thus, the regulation of corporate bond issuance ensures the protection of the public through a regulator-approved prospectus describing the issuer and the offered bond. The regulator attempts to ensure that the disclosure in the prospectus is comprehensive, accurate, understandable, and timely.[24] As a result, the issuer has to spend many months satisfying the regulator about these aspects before the regulator signs off on the prospectus.

[24] Some trade-off occurs among the four factors—comprehensiveness, accuracy, understandability, and timeliness—of disclosure. For example, if the issuer and the regulator try to make sure that a disclosure is comprehensive and accurate, the disclosure document may become less easy to understand or less timely to use

In advanced markets, however, the majority of corporate bonds are normally placed with institutional investors because of the intrinsic characteristics of corporate bonds. Occasionally, affluent investors may also participate in the primary distribution of corporate bonds. Few retail investors subscribe to primary issues of corporate bonds or buy them in the secondary market. Therefore, the corporate issuer usually prefers targeting its bonds to non-retail investors, unless the retail market offers exceptional opportunities that cannot be ignored. Many bond issues can avoid involving retail investors.

Advanced markets have developed offering methods for securities that make such offerings expeditious and cost-effective to non-retail investors. These methods are traditional private placements, institutional offerings, and shelf registration. Different disclosure standards apply to different kinds of investors and different circumstances depending on target investors' financial sophistication and resourcefulness as well as on the availability of periodic disclosure. Regulators impose less or no disclosure on securities offerings targeted to financially sophisticated and resourceful investors. Credible issuers whose information is reliably available from periodic reporting may be required to provide only minimal offering disclosure at a takedown.

So far, corporate bonds in emerging markets do not appear to differ from those in advanced markets in their intrinsic characteristics. Moreover, bank deposits dominate private savings, and non-bank intermediaries in most emerging markets do not have the resources to maintain the extensive retail distribution network that exists in advanced markets. In such an environment, helping the issuer target its bond issues to non-retail investors is one of the first strategic choices to catalyze corporate bond market development. Nonetheless, many emerging markets do not have the regulatory framework for corporate bond issuance that may economically best suit the targeted investor base. The absence or insufficiency of the regulatory framework may also be attributable to the underdevelopment of institutional investors in emerging economies.

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for making an investment decision. This trade-off is a basis for adjusting disclosure requirements to target investors' characteristics.

4.3 Differentiated Protection

The indiscriminate approach represented by a public offer filing in emerging economies may be responsible for disconnecting corporate bond issuers and investors. The disclosure requirements and procedures for corporate bond issuance in emerging markets are largely designed to protect the least sophisticated and least resourceful group of investors. Compliance with these procedures is unnecessarily expensive in cost and time to issuers, given that the most likely investors in corporate bonds are financially sophisticated and resourceful institutions. In the initial state of corporate bond market development, a regulatory mismatch occurs between the issuer and the investor.

The regulator can differentiate the degree of investor protection by the type of investors. U.K. law is explicit in this respect. In considering what degree of protection may be appropriate, the regulator is required to take into account the differing degrees of experience and expertise that different investors may have.[25] Those investors who usually do not have full protection under securities laws are affluent or financially sophisticated. They normally include institutions such as banks, brokers, dealers, pension funds, insurance companies, and mutual funds, as well as natural persons who have a high net worth or a large annual income.[26] They may also include insiders, such as directors and executive officers of the issuer.[27]

Differentiated protection would help prevent dual regulatory costs to protect end investors. The government regulates and supervises most institutional investors to protect their beneficiaries, or end investors.[28] The government should ensure that each regulated institutional investor is staffed with competent managers and professionals and that their financial dealings are prudent. Meanwhile, the government also regulates and supervises the securities market to protect the public, for example, by making sure that the issuer's

[25] See section 5(2)(b) of the Financial Services and Markets Act 2000.

[26] In the U.S. market, they include "any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management" is defined as an *accredited investor* (section 2(a)(15) of the Securities Act of 1933; section 230.501(a) of the *Code of Federal Regulations*; section 77b(a)(15) of the *United States Code*). Under the Prospectus Directive of the European Union, they are defined as *qualified investors* (article 2(1)(e)).

[27] See section 230.501(a)(4) of U.S. *Code of Federal Regulations.*

[28] Such beneficiaries are contributors of pension funds, policyholders of insurance companies, unit-holders of mutual funds, and so on.

disclosure is comprehensive, accurate, understandable, and timely and that the intermediary's conduct is fair. If regulated institutional investors are compelled to invest in publicly offered securities, the public pays regulatory costs for the protection of its interests twice. Occasionally, such double regulation and supervision may be desirable or unavoidable; however, a policy effort can minimize it in the public interest. Keeping a regulator accountable distinctly for its own regulatory objective would be preferable.

5. Economical Offering Methods

Adopting offering methods better suited to non-retail investors will likely make bond issuance an economical financing option for corporate issuers in emerging economies. The corporate bond market is likely to serve non-retail investors well in three ways: traditional private placements, institutional offerings, and shelf registration facilitated by integrated disclosure (Table 5.1). Traditional private placements are normally suitable for small and medium enterprises (SMEs) or unlisted closed companies, such as family-owned companies. These companies dominate many emerging markets and need debt capital for growth because external equity capital is expensive to their controlling shareholders. Even large and established companies occasionally issue bonds privately to meet the needs of particular institutional investors. Institutional offerings could conveniently meet the debt-financing need of well-established but unlisted companies and foreign governments and companies. Public offerings facilitated by integrated disclosure, such as shelf registration in the U.S. market and three-part disclosure in the Euro market, are generally suitable for seasoned, large, and frequent issuers.

Table 5.1: Comparison of Offering Methods for Corporate Bonds

	Private placements		*Public offerings*	
Characteristics	*Traditional private placements*	*Institutional offerings*	*Shelf registration*	*Stand-alone public offerings*
Suitable issuers	Any issuers, but notably SMEs and unlisted closed companies such as family-owned companies	Well-established but unlisted companies, as well as foreign governments and companies that publish periodic reports; some unlisted state-owned enterprises (with no exempt security status); some listed but infrequent issuers	Seasoned, large, listed, and frequent issuers (such as, utility companies, financial institutions, and foreign governments)	Well-established, listed, and infrequent issuers, including foreign governments and companies
Investors (offerees)	Institutional investors and affluent investors Mutual funds may invest in private placements if their investment policies permit.	Qualified investors (such as specified types of institutional investors) Some institutional investors are not permitted to invest in unlisted securities.	Mostly institutional investors, but occasionally retail investors	Mostly institutional investors, but occasionally retail investors
Investor protection	Usually none	Usually none	High	High
Disclosure and documentation	Voluntary and discretionary through an offering circular (information memorandum) but satisfactory to investors	Semiformal through a standardized offering circular (information memorandum), close to a public offer prospectus	Formal and full at registration (for example, once every 2 years), and integrated disclosure (incorporation by reference) for individual issues	Formal and full
Issuance process time	Short	Very short	Very short for individual issues	Long
Regulatory review and approval	Not required	Not required	Required once a registration period (for example, every 2 years), but not for each issue	Required
Trading	Highly restricted and may be locked up for some years	Tradable among qualified investors, some liquidity	Freely tradable, more liquidity than institutional offerings	Freely tradable but mostly inactive
Confidentiality	High	Very low	None	None
Covenants	Tight	Loose or none	Loose or none	Loose or none
Credit rating	Generally not required	Not required but preferable	Generally required	Generally required
Listing	Not allowed	Generally not required[a]	Generally required	Generally required
Investment yield	Generally high	Generally low but may be higher than public offerings	Generally low	Generally low
Total issuing costs (including opportunity costs)	Low	Low	Low for frequent and large-size issuers	High

	Private placements		*Public offerings*	
Characteristics	*Traditional private placements*	*Institutional offerings*	*Shelf registration*	*Stand-alone public offerings*
and market risk				
Issue size	Small to medium (although in an advanced market, private placements of a large size are not uncommon)	Medium to large	Large (a large size is desirable for economies of scale)	Large (a large size is desirable for economies of scale)
Structure	Flexible or tailored to the issuer's or investors' specific needs	Standardized, but could vary for individual issues (for example, medium-term notes)	Standardized, but could vary for individual issues	Standardized
Renegotiation of bond terms	Highly possible and flexible	Inflexible and difficult	Inflexible and difficult	Inflexible and difficult
Preconditions in the market structure			A well-organized report filing system at the regulator and an adequate and credible market following of shelf-registration issuers	

Source: Author.
Note: a. May be listed on an "exchange-regulated market", but not on a regulated exchange.

5.1 Traditional Private Placements

Traditional private placements refer to offerings of securities that are made to no more than a certain number of investors and that are exempt from the requirements of securities registration or prospectus filing. This definition is narrower than what is commonly known as private placement. Traditional private placements do not include small issue offerings that are exempt from securities registration or prospectus offerings because of the small issue amounts. They do not include institutional offerings either.[29] *Private placements* may be broadly defined as offerings of securities that are not made to the public, including institutional offerings and other types of offerings. They are subject to restrictions imposed on the issuer and the investor to qualify for the exemption.

Market intermediaries may place traditional private placements on an agency basis[30] or may underwrite them. A syndicate, even if formed, is not large. Financial institutions, such as insurance companies, investing in a traditional private placement may be allowed to act as an intermediary for the rest of the issue. Intermediation may involve coordinating bilateral negotiation between the issuer and prospective investors on the terms and conditions of the issue, including covenants.

5.1.1 Salient features of traditional private placements

Issuers often find traditional private placements advantageous because of their low issuance costs, speed, confidentiality, and re-negotiability (Figure 1.1 and Table 5.1). At the same time, traditional private placements allow the investor to demand that the issuer discloses information as needed and accept covenants negotiated for each financing situation and to monitor the issuer's performance closely. Traditional private placements also allow the investor to renegotiate the terms of bonds flexibly, should the issuer either become more creditworthy or technically default. These features culminate in lower issuing costs to certain issuers, such as SMEs or unlisted closed companies such as family-owned companies.

[29] Carey and others (1993) and Prowse (1997) distinguish traditional private placements from Rule 144A issues, which are institutional offerings in the U.S. market.

[30] Intermediaries acting on an agency basis are called *placement agents* or *arrangers*.

Confidentiality and tailored disclosure alleviate the problem of information asymmetry between the issuer and the investor. In traditional private placements, the issuer would be willing to disclose more information to its targeted or committed investor than to the public in public offerings. The investor can conduct direct and close due diligence instead of relying totally on the intermediary for due diligence, as in a public offering, thereby reducing the information asymmetry problem (Emerick and White 1992; Krishnaswami, Spindt, and Subramaniam 1999). Thus, the investor can more accurately assess the value of a traditional private placement than a public offering.

The investor's monitoring of the issuer's performance, together with the discipline that custom-made covenants impose on the issuer, would reduce the issuer's agency costs[31] (Berlin and Mester 1992; Blackwell and Kidwell 1988; Jensen and Meckling 1976; Krishnaswami, Spindt, and Subramaniam 1999; Kwan and Carleton 1995, 2004; Malitz 1994; Smith and Warner 1979; Yaman 2005). Traditional private placements are more effective in controlling the conflicts between the bondholder and the stockholder than public offerings are. Consequently, the investor could accept a lower yield on the issuer's privately placed debt than on a public offering.[32]

Traditional private placements may lower direct issuing costs by reducing the information asymmetry and agency costs, thereby saving issuance expenses. The reduction of the information asymmetry and agency costs will likely lower the yield to maturity of debt issues. The exemption from filing a prospectus with the regulator will save the issuer direct costs, such as fees payable to the regulator, printing expenses, underwriting and placement fees, and listing fees (Blackwell and Kidwell 1988; Carey and others 1993; Krishnaswami, Spindt, and Subramaniam 1999).

In addition, the renegotiability of bond terms can be valuable to the issuer as well as to the investor (Beneish and Press 1993; Carey and others 1993; Chen and Wei 1993; Emerick and White 1992; Kwan and Carleton 1995, 2004; Malitz 1994; Smith 1993). A renegotiation event may occur in two situations: (a) with its improved creditworthiness, the

[31] Such costs include those related to risk shifting, underinvestment, and cash flow problems.

[32] The owner, manager, or controlling shareholders of the issuer may see this reduction of agency costs as the cost of monitoring external capital to the extent that they lose the ability to extract private benefits from the issuer.

issuer wants to have the covenants relaxed so that it can run its operations more flexibly, or (b) the issuer wants to survive an unexpected but manageable adverse situation, such as a technical default. In an adverse situation, the issuer may attempt to hold on by implementing a new business strategy. In either situation, the investors—who are small in number, well informed, and sophisticated—will likely be capable of assessing the viability of the issuer under the new conditions. They will likely consider accepting the renegotiated terms of the bond if they find more value in the renegotiated terms than in the existing terms (for example, the immediately liquidated value of the issuer, or smaller distress costs).

5.1.2 Relevance to emerging economies

Traditional private placements can play a significant role in emerging economies. Issuers characterized by information asymmetry and agency problems are dominant in many emerging economies. Such issuers include SMEs, family-owned companies, or small free-float companies. In addition, the business environment prevailing in emerging economies tends to amplify information asymmetry and agency problems. Legal, regulatory, corporate governance and accounting frameworks are often weak in emerging economies.

In family-owned or small free-float companies, the owner or the controlling shareholder tends to be reluctant to disclose inside information to the public. Under an incomplete system of legal protection, the owner or the controlling shareholder may be selective in sharing inside information with the public for competitive reasons or for his or her private benefit. Family-owned or small free-float companies are likely to overlap SMEs.

An expeditious issuing process of traditional private placements, compared with the public offering process, may be of great value to issuers in many emerging markets. The review process of a public offering prospectus tends to be prolonged and uncertain in many emerging markets, thus causing the issuer a great opportunity loss. Besides reviewing a prospectus, the regulator also scrutinizes the offering on its merits if the regulatory system is merit based. If the regulator is constrained in resources, experience, or capacity, approving a prospectus may take a few to several months or more. The regulation may set a reasonable period in which the regulator should approve or disapprove the prospectus, but the issuer and the intermediary often complain that the regulator does not formally accept the application for prospectus approval until it understands the contents of the prospectus. Pre-offering

marketing activity, including book building, is not allowed before prospectus approval. Traditional private placements would eliminate or alleviate such opportunity loss.

The market of traditional private placements can serve as a testing ground for products new to an emerging market. Many debt products have yet to be introduced into emerging markets. The regulator may not be sure how to regulate a new product to protect the public in the local context. Hence, the existing rules and regulations may not be adequate for the new product. Traditional private placements would familiarize the local market with the new product. Without exposing the public to risks prematurely, traditional private placements would also allow the regulator to learn how the local legal and economic framework may or may not work for the product. Some structured products such as asset-backed securities may be too complex for the public by nature. Traditional private placements could be a cost-effective way for sophisticated market participants to benefit from such complex products.

Traditional private placements can allow debt products to meet the issuer's needs flexibly in the absence or dearth of cash management and hedging instruments in emerging markets. They can accommodate nonstandard features of bond cash flows such as delayed takedowns and early and partial repayments. Publicly offered debt issues are increasingly structured to have a "bullet" repayment[33] to appeal to the broadest possible universe of the public. As a result, the issuer of a publicly offered debt has to manage unmatched cash flows and may desire to hedge its market risks. Instead, the issuer in an emerging market, who does not have access to effective cash management and hedging instruments, may choose traditional private placements to avoid the need for sophisticated cash management or a hedging operation.

Traditional private placements help circumvent the underdeveloped retail distribution network in many emerging markets. A retail network entails large fixed costs. Commercial banks are likely to be the only financial institutions that can afford to have an extensive retail network in most emerging economies. Nonetheless, banks in emerging economies usually do not have incentive to distribute financial products that may compete with bank deposits.

[33] The whole principal of an issue is repaid in a single repayment at maturity.

Therefore, traditional private placements are a practical way for the issuer in an emerging economy to access investors directly.

Traditional private placements appear amenable to Islamic requirements for debt. Most Islamic countries are emerging economies. Many of their prospective issuers in the private sector have the profile of traditional private placement issuers. Their markets are also in short supply of long-term investment products that are compatible with Islamic requirements (*Shari'ah*). Islamic requirements—such as having a non-interest-bearing nature, being asset linked, requiring collateralization and risk-profit participation, and imposing certain restrictions on trading financial claims (that is, trading of pure debt only at par)—can curb the tradability of Islamic products. *Takaful* insurance companies and Islamic mutual funds would benefit from an increased availability of Islamic medium- and long-term debt products through traditional private placements.

Experience in traditional private placement may help prepare the issuer for the institutional offering market—and later for the public offering market. The traditional private placement market is open ended for the issuer. It could be a springboard for more extensively marketed or larger issues of the issuer's bonds. The issuer will preliminarily learn about the disclosure and issuance process at a much lower cost through a traditional private placement than with a stand-alone public offering. Concurrently, key investors and intermediaries will come to know more about the issuer. The issuer will be able to upgrade its disclosure documentation and sophisticate its cash management or financial planning through a gradual process from traditional private placements to public offerings.

5.1.3 Regulatory framework

The regulatory framework for traditional private placements needs to satisfy three key elements: exemption, clarity, and protection. The regulation needs to exempt the issuer and the intermediary from prospectus filing requirements, set clear conditions for the exemption, and still protect the public.

The exemption from prospectus filing requirements (*safe harbor*) is aimed at minimizing or eliminating the issuer's or the intermediary's liability under the public offering provisions of the securities legislation. Neither the issuer nor the intermediary of a traditional private placement is required to file a prospectus or other information documents with the

regulator for its approval. Preferably, the issue should not be subject to any prescreening. The issuer and the intermediary will not be held liable for noncompliance with disclosure requirements for a public offering; however, they should remain liable for fraud, including material misrepresentation or omission in connection with the private placement. They may be exempted from some other procedural requirements under the securities legislation. As a result, the information on a private placement that the issuer and the intermediary provide to the investor can be less than or different from that in a regulator-approved prospectus.

The clarity of the rules for the exemption underpins the economy of traditional private placements. Many emerging markets have some rules for traditional private placements in place, but their rules are often not clear enough. In such a case, the issuer or the intermediary is compelled to "consult" or "informally clear" with the regulator, which defeats the primary purpose of traditional private placements. A set of clear rules, when consistently applied, enhances the predictability of law. Ideally, the rules need to be so clear that the issuer and the intermediary, by acting on the rules, may comfortably place bonds without prior clearance from the regulator. In advanced markets, the issuer and the intermediary rely on a legal opinion by their legal counsel. Otherwise, ambiguous or insufficient rules—or their inconsistent application—would likely make the legality of a traditional private placement uncertain, thus increasing the cost of the placement.

In traditional private placements, the regulator protects the public in a different manner from that used in public offerings. An objective of securities regulation is to protect financially unsophisticated and resource-constrained investors both in public offerings and in private placements. The regulator's primary role in a public offering is to ensure that the disclosure is accurate, comprehensive, timely, and understandable. In a private placement, the regulatory goal is that no privately placed securities should leak out to unqualified investors or to more than a lawful number of investors (leakage).

The traditional private placement rules generally qualify investors, on the basis of their type or number, and restrict general solicitation (placement restrictions). Such investor qualifications typically include the following:

- Institutional investors, including banks, cooperatives, securities firms, insurance companies, mutual funds, and pension funds

- Corporations with assets of at least a specified amount
- Affluent individuals with assets or income of at least specified amounts
- Nonresident or foreign investors[34]

The restriction on general solicitation is concerned with the potential that non-qualified investors may be approached in soliciting orders for offered securities. It prohibits the issuer or the intermediary from contacting non-qualified investors or from marketing securities in a way that exposes non-qualified investors to information on the securities. An information document may be circulated only to qualified investors. Advertisements or indiscreet communications are normally not allowed.[35]

A number of investors ranging roughly from 35 to 100 is generally a factor in qualifying an issue for the exemption. However, the way the number is counted varies from jurisdiction to jurisdiction. The number is usually counted in a certain period of time to prevent the exemption rule from being abused. Table 5.2 shows some country examples of the number of investors qualifying for the exemption. The issuer is usually required to ensure that the investor is a qualified investor for private placements and purchases privately issued securities for investment but not for distribution. The issuer is also required to make sure that the investor fully understands the merits and risks of the securities and the restrictions attached to them. Although exempted from the disclosure requirements of a public offering, the issuer is usually required to disseminate sufficient, current public information concerning the issuer and the securities. The issuer typically produces an information document about the issue, commonly known as a *private placement memorandum*, *information memorandum*, or *offering circular*, which may be circulated without general solicitation.

The resale of privately placed bonds is normally restricted (resale restrictions). The investor is not allowed to resell the securities for a certain period (the holding period)—for example, one or two years[36]—unless the investor's circumstances have unexpectedly

[34] Nonresident and foreign investors may be viewed simply as those outside a country's jurisdiction rather than as being qualified for private placements.

[35] Posting information about the securities on a Web site without password protection is likely to be construed as advertising.

[36] The U.S. Securities and Exchange Commission shortened the holding period from two years to one year in 1997 and to six months in February 2008 for restricted securities of issuers that are reporting companies.

Table 5.2: The Number of Investors for a Traditional Private Placement

Country	*Number of investors*	*Remarks*
European Union	100 investors or less per EU member state	Unlimited number of qualified investors
Japan	49 investors or less	Unlimited number of qualified institutional investors
United Kingdom	No more than 50 persons	Unlimited number of various qualified investors
United States	35 nonaccredited investors or fewer	Unlimited number of accredited investors

Sources: Laws and regulations of the respective jurisdictions.

changed. The subsequent investor also must be a qualified investor. When the issuer is required to ensure the resale restrictions as well as the placement restrictions, the issuer may require the investor to sign an investment letter.[37] Alternatively, the issuer may place a private placement legend[38] and elaborate the restrictions in an information document or a purchase agreement. A requirement to denominate a bond in a substantially large amount could be effective in restricting the placement and resale of privately placed bonds. These restrictive measures are aimed at preventing an issuer from disguising a de facto public offering as a private placement to evade disclosure requirements.

The issuer of a private placement may be required to report the transaction information of the issue to the regulator. Even ex post facto information would be useful for the authority in monitoring market activity and formulating and implementing better regulations. Low cost and greater confidentiality are two of many perceived advantages of private placements. The regulator should weigh actual reporting requirements against negative factors, such as increasing cost and decreasing confidentiality.

[37] An *investment letter* or *letter of investment intent* is intended to establish that the issuer complies with the qualifications for the exemption. In the U.S. market, the investment letter constitutes a basis for the seller's reliance on the exemption from securities registration (Rule 502(d) of Regulation D).

[38] A *private placement legend* is an emphatically written statement in certificates of securities and other securities offering documents that sets forth the unregistered status of the securities offered and their transfer restrictions. A country's securities law, its regulations, or rules may set the standard form of the legend. Placing a restrictive legend on a bond certificate is not effective when privately issued bonds are in book-entry form. In such a case, the issuer may be required to lodge a stop transfer order against the bonds with the transfer agent.

5.2 Institutional Offerings

Institutional offerings[39] are private placements or other exempt sales to specified types of institutions and other investors (qualified investors) that are readily resalable between qualified investors (Figure 1.1 and Table 5.1). Rule 144A issues and the majority of Euro bond issues exemplify institutional offerings. The private placement status of such offerings exempts them from securities registration and prospectus filing. The issuer may be required to prepare brief offering documents,[40] but these documents are not required to comply with the country's disclosure standards for public offerings. Nonetheless, unlike traditional private placements, they are readily resalable among qualified investors.

Qualified investors[41] generally include banks, brokers, dealers, pension funds, insurance companies, and mutual funds. In addition, they may include some non-financial companies and natural persons who have a high net-worth or a large annual income, depending on jurisdictions. They do not include retail investors. A country's securities regulations should clearly define *qualified investors* for institutional offering purposes. A clear-cut definition would be a first step toward preventing institutionally placed bonds from leaking to the retail market.

Institutional offerings would likely appeal to well-established but unlisted or non-investment-grade companies such as family-owned companies. The public market is closed or too costly for them. Some unlisted state-owned enterprises with no exempt security status and some listed but infrequent issuers may also find institutional offerings practical. Furthermore, listed companies may prefer them in a market that is not advanced enough to use shelf registration.

The immediate resalability of institutional offerings, however, requires their issuers to disclose information just short of disclosure required in public offerings. Because their secondary buyer cannot afford individual due diligence, the investor prefers issues with well-

[39] Institutional offerings are also known as institutional offers, institutional placements, and wholesale offers or offerings.

[40] In the U.S. market, a Rule 144A issuer that does not file reports with the Securities and Exchange Commission is required to provide a brief statement of the its business and its products and services, as well as its audited financial statements for the preceding two years (Rule 144A(d)(4)).

[41] Such investors are called *qualified institutional buyers* in the U.S. market (Rule 144A(a)) and *qualified investors* in the European markets (article 2(1)(e) of the Prospectus Directive 2003).

documented disclosure. Credit ratings may be desirable. Indeed, the U.S. law eventually grants the 144A securities holder and purchaser the right to obtain reasonably current information from an issuer that does not file periodic reports with the Securities and Exchange Commission (SEC).[42,43] The issuer of an institutional offering in the Euro market usually seeks to list bonds. Listing is meant to disseminate disclosure information periodically to facilitate secondary market trading in the over-the-counter market. The issuer normally lists bonds outside the European Union (EU) or on exchange-regulated markets to escape EU disclosure requirements.[44] Thus, institutional offerings facilitate low-cost and expeditious offerings with no regulatory review, along with immediate resalability.

Foreign issuers also are likely to use an institutional offering facility. Foreign issuers operating under disclosure standards different from ones in the market often benefit from accommodative disclosure requirements.[45] They can save reconciliation costs of financial statements and opportunity costs. Accordingly, Rule 144A issues by non-SEC-reporting firms[46] conveniently accommodate international issuers. Institutional offerings accounted for nearly 100 percent of corporate bond issues in the Singaporean market (Box 5.1). An institutional offering framework, together with an institutional investor base, could help develop the corporate bond market in some developing countries aspiring to be an international or regional financial hub.

[42] Rule 144A(d)(4).

[43] For example, issues by SEC-reporting firms accounted for 77 percent of 1,418 observed domestic Rule144A issues from 1997 to 1999 in the U.S. market (Livingston and Zhou 2002).

[44] Exchange-regulated markets in Europe are an alternative to the "regulated market" (regulated by the regulator of a member state) under the Prospectus Directive, allowing the issuers to avoid the need for a prospectus that is compliant with that directive. These exchange-regulated markets include the Alternative Securities Market of the Irish Stock Exchange, the Euro MTF Market of the Luxembourg Stock Exchange, and the Professional Securities Market of the London Stock Exchange.

[45] The Prospectus Directive has an exemption from the requirement to use International Accounting Standards for non-equity securities with a denomination of at least €50,000 (wholesale debt). Under a nonpublic or limited offering exemption in conjunction with Rule 144A, non-U.S. issuers are permitted to access qualified institutional buyers in the U.S. Rule 144A market without having to comply with SEC accounting and related requirements.

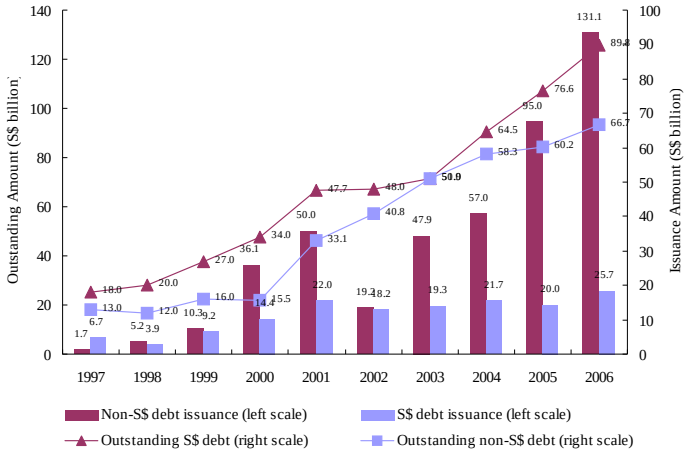
[46] Chaplinsky and Ramchand (2004) and Livingston and Zhou (2002) discuss, among other things, the relationship between U.S. disclosure requirements and foreign and domestic Rule 144A issuers.

Box 5.1: Corporate Bond Issues in Singapore

Singapore's corporate bond market consists of Singapore-dollar (S$) and non-Singapore-dollar segments in terms of currency. Although the former is growing modestly, the latter is larger and growing fast (Figure 5.1). Despite its short history, the Singapore corporate bond market is sophisticated. Both domestic and foreign issuers in the market routinely use medium-term note programs and special-purpose vehicle structures. Professionals in the market are abreast of new financial technologies and techniques.

Nonpublic offerings are dominant in the market. Public offerings of Singapore-dollar corporate bonds accounted for 35 percent of the total corporate bond issuance in 1999, when the market saw policy-induced public offerings by statutory boards. However, their share fell sharply to 1 percent in 2002. Public offerings of non-Singapore-dollar corporate bonds accounted for only 3 percent of the total corporate bond issuance in 1999, further declining to 0 percent in 2002 (Table 5.3). Although the same data for 2003 onward is no longer available,[47] the dominance of nonpublic offerings is considered to have continued. Unlisted bonds accounted for 56 to 81 percent of issues of nongovernment debt securities in terms of issue amount from 2003 through the first quarter of 2007 (Table 5.4).

Figure 5.1: Size of Singapore Corporate Bond Market (1997–2006)



Source: Monetary Authority of Singapore

Table 5.3: Private Placements and Public Offerings of Corporate Bonds in Singapore (1999–2002)

		1999	*2000*	*2001*	*2002*
S$ issues	Private placement	65%	85%	96%	99%
	Public offering	35%	15%	4%	1%
Non-S$ issues	Private placement	97%	98%	99%	100%
	Public offering	3%	2%	1%	0%

Source: Monetary Authority of Singapore.

.

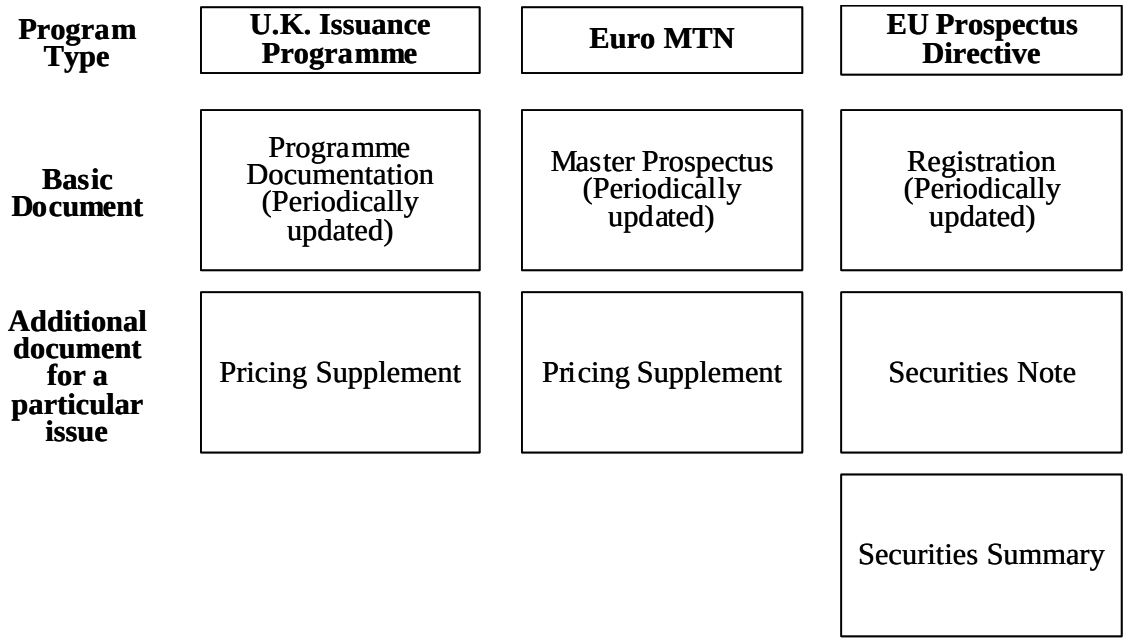
Table 5.4: Percentage of Issue Amounts of Unlisted Bonds in Issues of Nongovernment Debt Securities in Singapore (2003–07)

2003	*2004*	*2005*	*2006*	*2007Q1*
56%	68%	75%	67%	81%

Source: Monetary Authority of Singapore.

[47]The Monetary Authority of Singapore discontinued the collection of bond data on the basis of the breakdown between private placement and public offering in 2003.

Figure 5.2: Simplification of Documentation for Frequent Issuers



Source: Author.

Euro medium-term note (MTN) programs are another popular example of institutional offerings. They are the most predominant and speediest way to issue fixed income securities in the Euro market. MTNs are said to account for approximately 60 percent to 90 percent of Euro fixed income issues.[48] An issue can be closed in less than a week of the issuer's issuance notification. MTNs are issued on a syndicated or non-syndicated basis, continuously in series, through agents or dealers designated by the issuer. The issuer produces and maintains standardized documents, including the offering circular, for all its issues up to a certain aggregate amount of notes (master prospectus). Each time an issue is launched, its specific terms are set forth in a pricing supplement to the offering circular (pricing supplement) (Figure 5.2). Each issue of notes may vary in maturity (ranging from 2 to 30 years), currency, coupon rate, size, denomination, and other features.

5.3 Integrated Disclosure and Shelf Registration

Integrated disclosure allows the issuer to incorporate periodic disclosure documents by reference in its public offering documents, thereby easing the disclosure burden of public

[48] Petr (2007b) and a telephone interview with Mr. Ondrej Petr of International Capital Market Association, London.

Box 5.2: Bought Deal Compared with Book Building

The issuer's ability to tap the market expeditiously at a propitious moment (market flexibility) with shelf registration has intensified underwriter competition, thus resulting in the growth of bought deals, as opposed to book building.

A bought deal is a markedly efficient issuing method to the issuer, but it involves a large market risk to the investment bank. Bought deals tend to take place when the investment bank has a high degree of success in issue placement and deems the risk associated with the issuer or the securities to be small or manageable.

In a bought deal, the investment bank offers the issuer a firm price or a guaranteed spread over an index interest rate at which to underwrite (buy) the whole issue. The issuer chooses the investment bank, depending mostly on the competitiveness of the price or the spread. On the issuer's acceptance of the offer, the investment bank reoffers the securities to the market through a syndicate at the committed price or rate.

In establishing the firm price or the guaranteed spread, the investment bank takes into account a range of factors. They include (a) general factors, such as the current level, volatility, and outlook for interest rates and the yield curve; (b) issuer-specific factors, such as the issuer's rating, sector, and frequency of issuance in the particular market; (c) issue-specific factors, such as the issue size and structure; (d) market-specific factors, such as the supply and demand situation in the targeted group of investors and the placement power of prospective syndicate members; and (e) the investment bank's own factors, such as its overall business relationship with the issuer and its financial position.

A book-building method exposes the investment bank to less market risk; however, uncertainty to the issuer increases. When the issue is large or difficult or the issuer wants a greater degree of control on the bond's success, the book-building method is the likely one adopted.

In the book-building method, the investment bank wins from the issuer the mandate to lead an issue, mainly on the basis of an indicative price or rate. The investment bank's relationship with the issuer and market reputation play a significant role in the issuer's selection of the lead manager. As the lead manager, the investment bank pre-markets the issue through its own sales force as well as through invited syndicate members. On the basis of feedback from premarketing and coordination with the issuer and major syndicate members such as co-lead managers, the investment bank establishes a price range for the issue. The lead manager and the syndicate members solicit from prospective investors' interest in the issue against the price range (price talk) to fill the order book (book building).

The time for premarketing and price talk ranges from hours to days, depending on the issue's attractiveness to investors. Analyzing demand for the issue by demand attributes, such as spread level, strength of interest, and type and region of investor, the lead manager prices the issue and immediately launches it. To establish an indicative price or rate, the investment bank considers almost the same factors as those for a bought deal.

offerings (Figure 1.1 and Table 5.1). Every issuer with publicly offered securities outstanding continues to disclose periodically by filing reports with the regulator, such as quarterly, semiannual, and annual financial statements. In addition, the regulation in most countries requires the issuer to disclose material events promptly and file reports on them with the regulator. Then the qualified issuer is allowed to file these disclosure documents for a new public offering by incorporating periodic disclosure documents by reference. Offering and

periodic disclosure documents are substantially redundant, though their objectives are different. Integrated disclosure minimizes the redundancies.

Integrated disclosure has brought about shelf registration in the U.S. market. The issuer files a registration statement (base prospectus) for an anticipated public offering or offerings with the SEC for review and approval. The prospectus remains effective for two years. Seasoned reporting issuers, including those issuing non-convertible debt securities with an investment grade rating,[49] are not required to file a post-effective amendment. At a takedown, the issuer files a prospectus supplement with the SEC. The supplement contains the terms of the new securities, the underwriting arrangements, and all material changes in the issuer's affairs. The qualified issuer may incorporate the material changes by reference to periodic reports by means of a statement to that effect in the supplement.[50] The SEC does not usually review the supplement. Therefore, shelf registration allows the issuer to tap the market expeditiously at a propitious moment (market flexibility), thereby intensifying underwriter competition and resulting in the growth of bought deals (Box 5.2).

The EU introduced a system equivalent to shelf registration by means of the Prospectus Directive in 2003.[51] The new system for registration of documents allows the publication of the prospectus as a set of disclosure documents instead of as a single prospectus document. A prospectus is split into a Registration Document, a Securities Note and a Summary Note – each of which may circulate separately. The Registration Document contains the information related to the issuer, and is updated yearly. The Securities Note contains the information related to the specific securities issued and is produced at the time of the issuance. The Summary Note contains a résumé of the two documents and the risk warning. The disclosure is complemented by incorporation by reference. This system

[49] I. Eligibility Requirement for Use of Form S-3, General Instructions, Form S-3. Seasoned issuers with a good track record in periodically filing all reports are eligible for Form S-3.

[50] Items 11 and 12 of Form S-3.

[51] Institutional offerings remain dominant, however, apparently satisfying debt financing needs in the market. Although the Prospectus Directive was intended to foster cross-border public offers through a passport mechanism in the European Economic Area (EEA), incompletely harmonized disclosure regimes across the EEA continue to inhibit the development of a single public offering market. As a result, the choice for the issuer is effectively between public offerings in a single country or a few selected countries and institutional offerings. (Craven 2007, Petr 2007a).

apparently is based on an MTN program in the Eurobond market and may also be viewed as an evolution of shelf-registration in the U.S. market (Figure 5.2).

Integrated disclosure and shelf registration may serve as an incentive for better periodic disclosure in emerging markets where the regulator can demonstrate their benefits. Criteria for being eligible for integrated disclosure and shelf registration may include the issuer's flawless reporting record and corporate governance as well as the issuer's size and the quality and type of securities offered. Consequently, shelf registration is likely to serve seasoned, large, listed, and frequent issuers (for example, utility companies, financial institutions, and foreign governments) well. Preconditions for adopting shelf registration would include a well-organized report filing system at the regulatory agency and an adequate and credible market following of shelf registration issuers in the private sector. Periodic reports should be easily accessible to the public. The market should have intermediaries and analysts regularly researching shelf registration issuers.

Integrated disclosure may complicate a liability issue in disclosure, while shelf registration may fail in due diligence. In the U.S. market, the issuer's defense against liability for material misrepresentation or omission in offering disclosure is harder than in periodic disclosure. Integrated disclosure, together with real-time disclosure, would expose the issuer to more liability in filing periodic reports than nonintegrated disclosure, potentially chilling disclosure practice (Martin and Robinson 2003). Emerging markets are also likely to differentiate liability for material misrepresentation or omission in disclosure between offering documents and periodic reports because the motivation behind them could be significantly different.[52] Meanwhile, the net effect of shelf registration has been debatable. Shelf registration has enhanced underwriting competition but has reduced the underwriter's ability to conduct thorough due diligence (Allen, Lamy, and Thompson 1990; Blackwell, Marr, and Spivey 1990; Choi and Gulati 2006; Fox 1984; Kidwell, Marr, and Thompson 1984, 1987).

[52] The Indian market has different liability regimes for offering and continuous disclosures (Parekh 2005).

6. Conclusion

Broadening the offering methods for corporate bonds would help invigorate corporate bond market development in emerging markets. Primary market efficiency significantly determines the activity level of a corporate bond market. Aligning disclosure requirements with an actual investor profile would help reduce the issuing costs of corporate bonds substantially. The core investor base for corporate bonds is normally non-retail investors. Nonetheless, the regulatory focus of corporate bond issuance has inappropriately been placed on protecting the public in many emerging markets. The indiscriminate approach represented by a public offer filing may have disconnected corporate bond issuers and investors in emerging economies. Instead, the regulator can differentiate the degree of investor protection by type of investors to reach the core investor base of corporate bonds effectively.

The most critical cost element in a stand-alone public offering could be the uncontrollable opportunity costs in complying with disclosure requirements. The issuing cost model presented in this paper implies some of the borrower's behavior. First, good prospects for the project may discourage the borrower from a public bond issue. Second, the uncertainty of the ultimate opportunity cost may turn the borrower toward a bank loan, whose cost is relatively certain. The pre-launch period may become infinite or extremely long, should the borrower miss a market window for the bond issue. Third, the borrower's choice between a bond issue and a bank loan could be highly sensitive to the length of the pre-launch period.

The issuer often finds traditional private placements advantageous because of their low issuing costs, speediness, confidentiality, and re-negotiability. Furthermore, traditional private placements can play a significant role in emerging economies. Their expeditious and relatively predictable issuing process may be of great value to issuers by significantly reducing opportunity costs. Their market can serve as a testing ground for products new to an emerging market. They allow debt products to meet the issuer's needs flexibly in the absence or dearth of cash management and hedging instruments in emerging markets. They help circumvent the underdeveloped retail distribution network. They also appear amenable to Islamic requirements for a debt-like obligation. Traditional private placements will enable SMEs or unlisted closed companies, such as family-owned companies, to access debt investors directly.

The regulatory framework for traditional private placements needs to satisfy three key elements: exemption, clarity, and protection. Exemption is aimed at minimizing or eliminating the issuer's and the intermediary's liability under the public offering rules. The exemption rules need to be so clear that the issuer or the intermediary, by acting on the rules, may comfortably place bonds without prior clearance from the regulator. In traditional private placements, the regulator protects the public by imposing restrictions on placement and transfer of bonds rather than by enforcing disclosure.

Institutional offerings commonly refer to private placements made to specified types of institutions and other investors (qualified investors) that are readily resalable between qualified investors. Qualified investors generally include banks, brokers, dealers, pension funds, insurance companies, and mutual funds. Institutional offerings would conveniently meet the debt financing needs of well-established but unlisted companies and foreign governments and companies. Some unlisted state-owned enterprises with no exempt security status and some listed but infrequent issuers also are likely to use an institutional offering facility.

Integrated disclosure allows the issuer to incorporate by reference into its public offering documents periodic disclosure documents, thereby easing the disclosure burden of public offerings. Integrated disclosure has brought about shelf registration. Integrated disclosure or shelf registration may serve as an incentive to better periodic disclosure in emerging markets when the regulator can demonstrate their benefits. Preconditions for adopting shelf registration would include a well-organized report filing system at the regulatory agency and an adequate and credible market following of shelf registration issuers in the private sector. Integrated disclosure may complicate a liability issue in disclosure, while shelf registration may fail in due diligence. Shelf registration facilitated by integrated disclosure is likely to serve seasoned, large, listed, and frequent issuers (for example, utility companies, financial institutions, and foreign governments) well.

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